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M&A DIALOGUE

LEGAL, TAX, FINANCIAL NEWS

Issue: May 2020

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→ Vendor's duty of disclosure owing to the coronavirus crisis

The coronavirus crisis brings with it a number of new legal risks in the context of the sale of a company. One of these risks is the duty of disclosure on the vendor, which may be significantly aggravated by the special circumstances, especially due to the loss of customers or supply chains, any threat of insolvency and business shutdowns. The vendor therefore has extensive duties of disclosure which must urgently be considered. If there is any fraudulent or intentional breach of this, then there is a risk of purchase price adjustments, payment of damages or even the reversal of the contract.

GENERAL DUTY OF DISCLOSURE BY THE VENDOR

Every party normally has to obtain for themselves the information they require, and take the necessary steps to obtain disclosure of this information. There is no fundamental duty for the contracting parties to disclose all the facts without being asked. However, the Federal Court of Justice (BGH) has consistently ruled that the contracting parties must voluntarily disclose circumstances which could frustrate the purpose of the contract, and that are therefore of fundamental importance for the decision of the other contracting party.

In the case of the sale of a company, the vendor bears an increased duty of information and care, due to the economic importance of the sale of a company. If there is any fraudulent or intentional breach of the duty of disclosure, the vendor is liable; this liability cannot be excluded. The BGH will assume fraud if the vendor responds incorrectly by plucking answers "out of thin air" to questions that are obviously significant for the purchaser. "Out of thin air" means that the vendor provides an answer to a question despite his not knowing.

SPECIAL DUTY OF DISCLOSURE OWING TO THE CORONAVIRUS CRISIS

This obligation on the vendor to disclose information is expanded in scope due to the current coronavirus crisis. Special circumstances that arise due to the coronavirus crisis can have an immense economic impact and thus affect the purchase price. The vendor must inform the purchaser about the changed circumstances and events, as otherwise he will remain liable due to a breach of his duty of disclosure.

Some negative circumstances that may arise for the contracting parties as a result of the coronavirus crisis are the following:

- the (potential) customer base disappears due to the economic situation or due to cost-cutting measures by customers;
- there are significant bottlenecks in supplies to the company, because the supply chains or suppliers can no longer meet demand;
- the company is forced to shut down its business operations by the authorities;
- a significant collapse in revenue has been recorded;
- tenants have announced, or already applied for a deferral of rent payments or have not paid;
- legal employment measures (short-time working, redundancies) have been or need to be applied;
- the company to be sold is threatened with insolvency, or it has not yet been filed due to the suspension of legal obligations.

The vendor will not normally have greater knowledge than the purchaser with regard to the potential consequences of the coronavirus. However, the vendor must clarify where he has more knowledge of risks and loss of income than the purchaser thanks to domain knowledge, especially in relation to issues that are already occurring or can be specifically expected. Although the purchaser must also use his own due diligence to check for risks/loss of income that are possible or may already have occurred due to the coronavirus crisis, the due diligence process cannot discover all risks. For example, the purchaser will not normally be able to recognise on the basis of annual financial statements from 2019 how much turnover has been lost in the 1st quarter of 2020, meaning that using a fixed box mechanism makes it impossible to adjust the purchase price and therefore price in the loss of revenue or profit.

However, the risks and failures must be correctly priced in by the purchaser, making them extremely relevant for the level of the purchase price. This significantly increases the duty of disclosure and the preceding duties of information and validation on the vendor's part, based on the current economic situation, and greater attention needs to paid to complying with them. For this purpose, the close involvement and regular questioning of senior management and knowledge bearers is recommended. If the vendor decides to whitewash the impact or fails to disclose information, this may result in liability. In addition to a reversal of the contract or overall compensation, it is also conceivable that the purchaser may demand as compensation the difference in value had the vendor has made correct disclosures.

CONCLUSION

The coronavirus crisis is giving rise to increased requirements with regard to the vendor's duty of disclosure. The vendor must inform the purchaser about circumstances and measures caused by the coronavirus crisis, and thus find out more information about these himself. In the event of non-disclosure, there is a risk of the reversal of the purchase contract or a claim for damages, including for the difference in value.

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→ Post merger integration – tax actions required

Tax Compliance is a critically important part of any corporate transaction. In most cases, there is a general need for action when considering the results of the due diligence and the following transaction phases. In order to integrate the target company in a tax-optimised manner into the existing structure after purchase, the purchaser should deal with the target and the appropriate tax structure at an early stage in order to avoid tax disadvantages.

TAX COMPLIANCE WHEN SELLING A COMPANY

The sale of a company can have various implications in the areas of income taxes, real estate transfer tax, inheritance tax and value added tax. When acquiring a company by way of a share deal, the purchaser assumes all existing historical tax obligations of the company being acquired, which means he assumes extensive responsibility

for the tax matters and thus tax liability. In the case of an asset deal, on the other hand, the purchaser's liability is limited to certain types of taxes and certain time frames. The purchaser has an obligation to notify the transfer of business under Section 153 AO (Tax Code) in order to prevent any risks for the company, its management bodies and employees.

A Due diligence can deliver first indications of errors that happened in the past at the target company, e.g. in preparing the tax balance sheet or the tax declarations, which may trigger a need for action on the part of the new owner of the company.

In addition, the accounting system of the target company may need to be reshaped to match the group accounting practices. This may give rise to interfacing problems and/or a change of accounting system may be required.

Furthermore, the acquisition structure and the tax-optimum integration of the target company into the existing company may result in deadlines for notifications and vesting or holding periods, e.g. in relation to real estate transfer tax or conversion tax. As of 2020, there is also the new EU obligation for the reporting of cross-border tax structures.

SETTING UP AN OPTIMUM TAX STRUCTURE

In addition to Tax Compliance, a transaction also offers an opportunity for the integration of the target company in a way that optimises tax.

The purchaser will normally be seeking to deduct the financing costs of the transaction (in an international context ideally even doing so multiple times, referred to as "double dipping"). Since each company is in principle an independent tax entity and can therefore only offset expenses against its own income, it is advisable to look for offsetting opportunities outside the company as well. In Germany, a "debt push down" is possible e.g. by using a tax group or a merger.

Another important aspect in the acquisition of a foreign company is how to structure the transfer of future profits to the German shareholder in a tax-optimised way. Thereby, the burden of withholding tax should be reduced as far as possible or even eliminated by a smart combination of bilateral double taxation agreements and within the EU by applying the Parent-Subsidiary Directive.

The choice of legal form must also be born in mind when seeking an optimum tax structure. Hence, it can be advantageous to transfer a newly acquired corporation into a transparent or hybrid taxation structure or to select a suitable acquisition structure for this. For medium-sized entities, which often operate in the legal form of partnerships in Germany, a transparent tax structure via foreign partnerships can be advantageous in order to limit the overall tax burden to profits from abroad when they are repatriated to the German shareholder to the (usually lower) local tax level.

As part of the tax structure, special attention must be paid to checking whether the EU reporting obligation is triggered for cross-border tax planning arrangements.

CONCLUSION AND OUTLOOK

The Tax Due Diligence represents a source of information which feeds into the tax compliance system, especially because the timely identification of the tax risks of a company and the completion of the "Action Items" it raises are decisive for its success. From a tax perspective, for example a transparent tax structure using partnerships may be advantageous. The specific action items, the determination of the optimum structure and its implementation require individual advice.

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→ Post merger integration during the crisis

The recent outbreak of Covid-19 and its immense impact on daily life and the global economy have shown that even the best managed project is not crisis-proof. How do you successfully navigate through an integration project in volatile times, and what must you keep an eye on?

A STRONG BACKBONE – CENTRAL PROJECT MANAGEMENT

Project management must be in a position to react quickly to external circumstances, and to shift the focus if necessary. The question “How can the project move forwards” should be clarified as soon as possible. In order to avoid over-hasty actions, we recommend inserting a “freeze phase”, during which all work streams stop their activities for a defined period, while the project management and steering committee consult on how the project should continue. In order not to create panic, it is essential that no asymmetry of information arises and that the period of the “freeze phase” is clearly communicated and justified. If circumstances are so unpredictable that no final plan B can be developed, as a minimum a step-by-step plan should be created for a number of scenarios. In addition, a new prioritisation of the work streams and areas for action will be necessary: what activities can, if necessary, be completely eliminated, greatly simplified or postponed until later? In addition, where does the crisis create the need for new actions?

THE SINGLE MOST IMPORTANT THING IS: COMMUNICATION

The major success factor of an (integration) project is the awareness of the participants how the processes can work “meaningfully” work within the project, and this generates the motivation to work together towards a goal. If the integration grinds to a halt thanks to external circumstances, then the project process is challenged and project members lose their bearings. In this phase, confidence in top management is particularly important and this can be significantly enhanced by early, goal-oriented and transparent communication. In addition to the regular project communication, it is possible to set up additional formats such as up-to-date newsletters about the crisis, video messages, etc. One-on-one conversations/telephone calls, and adequate feedback loops are also important. The following rule applies: the more personal the channel, the better, and also “when in doubt, over-communicate”. In the case of official information, however, care must be taken to ensure that the flow is managed, and managers/project managers are informed ahead of employees and they then share the information appropriately.

DURING A CRISIS, REMEMBER: CASH IS KING

In addition to reviewing the continued existence of the business model during the crisis, the soundness of the balance sheet of each of the companies - both the purchaser and the target company/ies - must be considered. If a company has less debts it needs to pay off, then the interest burden is low and there is a greater capacity to reduce the operating costs for the integration project. Even here, you have to view the company as a whole: not only the resources for the integration project need to be covered, but also the employees, suppliers, etc. want to be paid during a period of crisis. In addition to ensuring sufficient liquidity, we recommend that you step up the cycle for monitoring liquidity and, if necessary, move to weekly monitoring. In addition, communication should be initiated early on with relevant stakeholders, especially with the banks who provide financing, factoring companies, credit insurance companies and ratings agencies, but also with suppliers and customers.

ALL CRISIS - OR ALSO AN OPPORTUNITY: LEGAL AND TAX ASPECTS

The legal topics for integration projects are generally based on the findings of the Legal Due Diligence. In addition to the processing and, potentially, the adjustment of the individual milestones of the legal integration plan, especially in times of crisis, a regular contract and claim monitoring system should be set up. When selling a company, for example, the company taking over may be looking at claims against the vendors for additional purchase price adjustments, or arising from warranty or guarantee arrangements or non-

competition clauses, which only come into being and/or are recognised after the closing, or other motives may be created by circumstances relating to the crisis. Especially in times like these, the importance of cleanly drawn-up term sheets becomes apparent. For future agreements, we recommend including additional crisis scenarios (pandemic, etc.) in the framework conditions.

Also from a tax point of view, integration projects usually show some need for action. In addition to tax obligations that must be met following the merger of companies, the acquisition structure must be checked. There may be potential for streamlining, which might even be improved by a crisis. In particular, in the event of a crisis-related impairment of assets, it is worthwhile reviewing changes to tax structures which were not beneficial at higher values.

CONCLUSION

With or without a crisis – integration projects are usually complex and take place under high time pressure. They are inherently full of uncertainties that are further increased by a crisis. Managing a successful integration project in volatile times requires a combination of a robust "technical" solution and goal-oriented communication. The earlier the relevant changes are recognised and tackled, the better a crisis can be managed for the project under way. In addition, we recommend thinking "outside the box" and reacting flexibly to changes. By taking a second look, structural measures may be identified that allow the crisis to be turned into an opportunity.

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→ M&A Vocabulary – Explained by the experts

"Limitation of liability (de minimis, basket, cap)"

In this ongoing series, a number of different M&A experts from the global offices of Rödl & Partner present an important term from the specialist language of the mergers and acquisitions world, combined with some comments on how it is used. We are not attempting to provide expert legal precision, review linguistic nuances or present an exhaustive definition, but rather to give a basic understanding or refresher of a term and some useful tips from our consultancy practice.

A fundamental component of company acquisition contracts are the arrangements to limit the vendor's liability to the buyer. While the vendor is usually interested in being able to predict and restrict his overall liability, the purchaser usually attempts to provide complete cover for all the uncertainties relating to the company which is the subject or the transaction. These include, in particular, those uncertainties that were identified during the due diligence.

In this context, the vendor generally provides guarantees, e.g. for circumstances governed by company law, the ownership arrangements relating to the significant assets or to the existence of significant contracts. If guarantees are not honoured, the purchaser is basically legally entitled to submit a claim for the reinstatement of the situation which would exist, if no breach of warranty had occurred. Only as a fallback, if a claim to reinstatement of the situation is not successful or not feasible, can a claim for payment of damages follow.

The resulting legal consequences, contrary to the provision of unlimited liability generally prescribed by law, can be substantially modified or restricted by using **de minimis- basket-** or **cap liability** clauses or **caps**, in the purchase contract between the parties.

DE MINIMIS CLAUSES

A materiality threshold is agreed for a de minimis clause. The purchaser can only press claims for damages for breaches of the warranties against the vendor once this threshold, which is defined as a fixed amount, has been exceeded. This protects the vendor from the submission of many minor claims for compensation, which are immaterial compared to the agreed purchase price. At the same time, the de minimis clause helps to avoid a large number of legal disputes between the parties over minor amounts.

BASKET CLAUSES

Baskets are often agreed in connection with de minimis clauses. In this process, the claim items are first pooled, and can only be reimbursed or a claim made once the agreed sum (the threshold) is exceeded. Symbolically, all claims are put in a basket and as soon as the basket is full, they can be processed.

Two types of thresholds then exist - a deductible and a tipping basket. When a deductible basket is agreed, only claims that exceed the agreed amount can be submitted (excess only). A level of the deductible is agreed. Only the claims that exceed the basket can be enforced.

With a tipping basket, the total amount (first dollar) can be claimed once the total basket exceeds the agreed amount.

LIABILITY CAP CLAUSE

The liability cap clause for its part defines an upper limit to the amount, referred to as maximum liability limit or cap, up to which the vendor is liable. The cap relates to specific guarantees, such as ownership of the shares or title guarantee of the purchase price. Often, the Parties also agree on a lower cap relating to non-compliant warranty issues, based on a percentage of the purchase price. In cases of deliberate intent, the cap does not apply, and the damage must be repaid in full, i.e. unlimited.

LIMITATION PERIODS

In addition to provisions concerning the level of liability, the liability of the vendor is also usually

limited in terms of time (limitation periods). Care must be taken to ensure that longer periods of limitation or assessment periods apply in relation to tax claims. In practice, the time frame of the limitation of liability is normally between 18 and 36 months from the closing date, which is the date of completion of the purchase contract. In the case of violations of tax-related guarantees, depending on the country, liability may be customary for a period of up to six years from the closing date.

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M&A Dialogue |
May 2020 Issue

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